TESTIMONY OF RONALD D. KNUTSON
PROFESSOR EMERITUS, TEXAS A&M UNIVERSITY
BEFORE THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON AGRICULTURE
SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT

SEPTEMBER 21, 2006

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to appear before you today to address what I believe to be some of the major economic issues confronting you in designing future federal farm policy. There are a number of economic lessons learned from the past that can be applied to current and evolving economic conditions in agriculture. I draw on over 40 years as a policy analyst, as the former Director of the Agriculture and Food Policy Center at Texas A&M University, and as a former Administrator in the U.S. Department of Agriculture. The special interest I represent is as a member of the general public who is interested in an economically rational farm policy. In today's context, such a policy has multiple and sometimes conflicting goals of providing a safety net for farm income, expanding trade, improving efficiency, increasing energy independence, and conserving agriculture's resources. I will not address other important sections of the Farm Bill that deal with issues such as food safety, nutrition, rural development, research, and extension.

More often than not, farm policy has been developed in a crisis of low farm prices and incomes. This should not be the case for those farmers who have had the blessings of favorable weather in 2006 and 2007, when grain prices should be quite favorable, bolstered by strong biofuel demand. In this generally favorable economic environment, I encourage the Committee to boldly lay out the goals desired to be accomplished and changes that need to be made to serve the long-run interest of the agriculture community and the general public. The following represent my list of such needed considerations and options for the next Farm Bill:

1. Following the decisive moves of the 1996 Farm Act to decouple direct farmer payments, the 2002 Farm Act took a step back by adding the countercyclical payments, which are only partially decoupled, extending the marketing loan payments, and adding the MILC payments. While U.S. farmers were pleased with the increased support, the international reaction was decidedly negative due to the potential for production enhancing, market price depressing, and trade distorting effects. These 2002 Farm Act provisions were one of the factors that led to the Brazil WTO cotton litigation and arguably the impasse in the Doha Round of trade negotiations. It is important to note that the United States now lags the European Union in the level of decoupling, although the EU's overall level of farmer support continues to be higher than that of the United States.

   The expectation of generally favorable U.S. crop prices and incomes, if realized in 2007, makes this a good time to change the form of support by moving to a decoupled farm policy that is less trade distorting. There are a number of specific options for decoupling including a fixed payment, various forms of green payments, and various forms of targeting benefits not related to production and price. If you desire, these alternatives can be further expanded upon subsequently. Any movement toward decoupling programs has to consider the unintended consequence of rewarding those who are not at risk (landlords) at the expense of their tenants.

2. The combination of milk price supports and milk income loss contract (MILC) payments lacks economic consistency and logic. While I recognize that this subcommittee lacks jurisdiction over dairy programs, there is an overriding need for a consistent farm safety net policy across commodities. This exists in the program crops where it was learned in the 1970s that a target price set at a higher level than a support price that sets the market floor runs a substantial likelihood of leading to high CCC purchases and stocks. As a result, in 1985 Congress adopted the marketing loan for crops (initially for cotton and rice and later for all crops) as the main support mechanism and effectively eliminated the nonrecourse loan as the price floor. The dairy support program has a history of being plagued by periodically large CCC purchases, stocks, and the need to dispose of them through feeding programs, as animal feed, or through the Dairy Export Incentive Program (DEIP). This experience has been aggravated further by the MILC program.

   Options for the dairy program include either eliminating the price support program or MILC. From an economic perspective, eliminating the price support program while retaining MILC would be less trade distorting while counting less toward our amber box limits; would effectively deal with CCC storage and related cost issues; would yield consumer price benefits and expand trade; and would be more transparent. Recent experience and studies clearly suggest that U.S. dairy farmers producing a majority of the milk production are able to compete internationally. Dairy programs need to be adjusted to this reality.

3. The realities of CAFTA and NAFTA also require that our sugar policy be modernized, which is long overdue. First and consistent with my suggestions for dairy, a direct payment program is needed for sugar, which would substitute for the current production control and CCC support programs. Ideally, these direct payments would be decoupled. Steps need to be taken to utilize our sugar production capacity for ethanol. Direct payments, the elimination of production controls, favorable corn prices, and the utilization of extracted juice for ethanol will help in this regard. AFPC analysis indicates that, in the absence of sugar price supports, utilizing the Brazilian model of making ethanol from sugarcane juice, the U.S. sugar producers can be competitive with corn and with ethanol imports from Brazil. Making these policy changes would increase the sweetener market share for beet sugar as sugarcane is used to produce ethanol. A breakthrough in cellulose conversion technology would further boost the economic advantages of producing ethanol from sugarcane and, perhaps, from

sweet sorghum. This seals the case for increased public sector research on the development of cellulose conversion technology.

4. If anything is done on payment limits, I would suggest eliminating them completely because they either do not work or are counterproductive. They do not work, except in dairy, because of the array of legal loopholes that exists for avoiding them in crops. For crops, payment limits are one of the factors that has resulted in increased use of cash rental arrangements. The renter gets the direct payment, which is then ultimately passed on to the landlord as higher cash rent, meaning that for the landlord there is no payment limit, even though there may be one for the tenant. Tenants are further hurt by reliance on cash rents by having to absorb 100 percent of the production and financial risk, rather than sharing it with the landlord on a share rental arrangement. While payment limits work in the dairy MILC program, they penalize the largest and most efficient milk producers. In other words, payment limits are neither an effective nor an efficient way to target program benefits. I see no means of avoiding these counterproductive effects other than eliminating income support programs entirely.

5. If disaster payments are going to be continuously mandated by the Congress on an ad hoc basis, crop insurance subsidies need to be discontinued in favor of a permanent federal disaster program. The objective of such a program could be to compensate farmers for losses due to natural disasters where yields are unusually low relative to the farmer's yield history. Alternatively, the program could be expanded to provide revenue assurance to all farmers as a substitute for all current safety net programs, including crop insurance, all forms of direct payments, and any price support programs. As a starting point for considering these options, the CBO and FAPRI should be asked to evaluate the cost of these two options relative to the current baseline.

6. There is a danger that incentives for increasing bioenergy production could be excessive with adverse long-run consequences for farmers, for the use of agricultural resources, and for the future of farm programs. In raising this concern, I am not opposed to the use of agricultural resources for energy production where dictated by market conditions, which is currently not the case. Neither am I opposed to increased support for research and extension designed to increase energy yields from crops or to develop cellulous sources of bioenergy. In addition, as noted previously, program adjustments are warranted to increase the utilization of our sugar production capacity for bioenergy production.

   I am concerned that excess investment in bioenergy could adversely affect feed costs for poultry and hog producers, which would strengthen their case for demanding program benefits. It could also ruin our reputation as a reliable supplier for exports to countries that have come to depend on the United States for a supply of agricultural products at our urging. This concern affects subsidies and loan guarantees to encourage investment in bioenergy and the creation of barriers of trade in bioenergy. From an economic perspective, the U.S. price of bioenergy, the price of the feedstocks used to produce it, and investments in bioenergy production can best be determined by the market relative to the price of oil. The danger of not operating in this manner will get the United States mired down in government agriculture and energy adjustment programs for years to come.

Let me end my testimony by saying that I appreciate the difficult task that faces you in writing new farm legislation. Statesmanship and a continuation of accelerated communication by the Committee with your increasingly diverse constituencies and by Secretary Johanns will clearly be required as you move through the process. Due to time limits, I have outlined a few of the major improvements that could be made while retaining the farm program safety net, which is important to all interest groups. I am available now or at any time in the future to answer questions.

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PROFESSIONAL EXPERIENCE:

Professor, Agricultural Economics, Purdue University, 1967-73
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Administrator, Farmer Cooperative Service, USDA, 1973-75
Professor, Agricultural Economics, Texas A&M University, 1975-2001
Director, Agricultural and Food Policy Center, Texas A&M University, 1988-2001
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PUBLICATIONS

Knutson, Ronald D., J. B. Penn, Barry Flinchbaugh, and Joe L Outlaw, *Agricultural and Food Policy*, 6th Edition, Prentice-Hall, Inc., 2007.

Knutson, Ronald D. "Farm Policy Setting" in Joe L. Outlaw and Edward G. Smith, eds, *The 2002 Farm Bill: Policy Options and Consequences.* Oak Brook, IL: Farm Foundation, September 2001.

Knutson, Ronald D. and Edward G. Smith, eds., *1995 Farm Bill, Policy Options and Consequences,* Set of 36 papers. National Public Policy Committee, Farm Foundation, November 1994.

Knutson, Ronald D., E. G. Smith, and Barry Flinchbaugh, eds. *Policy Options and Consequences for the 1990 Farm Bill*, Set of 15 papers. National Public Policy Education Committee, Farm Foundation, January 1990.

INTERNATIONAL CONTRIBUTIONS

1995-03 Co-chair of annual North American Policy Disputes Information Consortium (PDIC) Workshops involving university, industry, and government policy leaders from Canada, Mexico, and the United States. Knutson was one of three professionals that developed the concept of PDIC that conducted nine annual workshops designed to reduce trade tensions under NAFTA.

2004- Co-chair of North American Agrifood Market Integration Consortium (NAAMIC). Knutson was one of four professionals that developed NAAMIC as a positive sequel to PDIC with the objective of fostering market and policy integration.

2006- Co-chair of CAFTA Agrifood Market Integration Consortium (CAMIC). Based on success in PDIC and NAAMIC, Knutson is one of two professionals involved in the organization of CAMIC as a USDA and IICA effort to foster market and policy integration under CAFTA. The first annual CAMIC Forum is being planned for October 2007.

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2004.

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1. **Please list any federal grants or contracts (including subgrants and subcontracts) you have received since October 1, 2004, as well as the source and the amount of each grant or contract. House Rules do NOT require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:**

Source: USDA **Amount:** 300,000

Source: USDA **Amount:** 30,000

2. **If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) the organization has received since October 1, 2004, as well as the source and the amount of each grant or contract:**

Source: ______________________ **Amount:** ____________

Source: ______________________ **Amount:** ____________

Please check here if this form is NOT applicable to you: ____________

Signature: Ronald D. Knutson

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